Transcript

Health Plan Administrative Costs: A Review of 2007 Results

September 17, 2008

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Welcome to our review of the benchmarking studies for Blue and Independent / Provider – Sponsored Plans. I believe that most of you are health plan managers with responsibilities for achieving that optimal mix of costs and benefits that lead to superior long term performance for your customers, your owners and the public at large. We appreciate the complexity of this task.

I would also like to welcome members of the investments community who are also joining us today. As a former research associate with Lehman Brothers Kuhn Loeb, I have the highest respect for analysts' role in our economy's capital allocation process, along with some sorrow for the sad end of Lehman's venerable name. Fortunately, while investment firms may come and go, the excellent analysts remain.

I want to thank all of you who are participants in our benchmarking studies. While participating plans tend to realize a return on their investment in the benchmarking process, it is nevertheless the case that the summary benchmarks that result are valuable to other firms as well. By the way, those of you who are in our Medicare universe now have drafts of Volume I and you should receive your final version next week. Remaining operational metric volumes for Medicaid and Independent / Provider-Sponsored plans will be delivered in coming weeks.

As you may know, this is our eleventh consecutive year of performance benchmarking for health plans. Our various universes serve more than 36 million Americans, or one of

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every five insured, and health plans serving one in every three insured people are users of our benchmarking studies.

Plans participating in our benchmarking studies agree to complete our survey form in exchange for the resulting report. Costs must be segmented by product as well as by functional area. Without belaboring the issue, we do have an array of very good checks to promote data quality.

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Today, I would like to touch upon trends in health plan administrative costs, the effect of organizational type and scale, and differences in the operating styles between plans of different sizes. This will be a fairly brief presentation because much additional content is available in *Plan Management Navigator* for June through September of this year. Then I'll try to answer any questions that you might have.

Before I begin, I'll periodically refer to two universes of health plans. One is comprised of Blue Cross Blue Shield Plans, which I think is self-explanatory, and the second we call Independent / Provider-Sponsored Plans. These plans are primarily owned by providers, but unlike many of the ones that failed in the past, *our* such plans maintain a strategic distance sufficient to be free of intersegment complexities, whether economic or accounting. This universe also includes those plans that are independent, but who have no current ownership interest by providers. The name we've given this universe, Independent / Provider-Sponsored Plans, is such an unfortunate mouthful that I'll often abbreviate it as "IPS" Plans.

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In 2007, both of our broadest universes, Blue and Independent / Provider-Sponsored plans, posted modest growth in PMPM administration. IPS grew by 4.9%, down from 11.8% in 2006. Blue plans cost growth also declined to 4.3% from 6.1% in 2006.

Both of the universes increased their offerings of very costly Medicare Advantage products, which distorted upwards real growth. On a weighted basis, Medicare Advantage share of the IPS product portfolio increased from 4.2% to 5.0%, while among Blues, Medicare Advantage share increased from 1.5% to 2.1%. Accordingly, after backing out the effect of this and other mix changes, Blue PMPM costs increased by

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2.5% rather than the 4.3% as reported. Also, IPS cost increased by 3.0% PMPM rather than the 4.9% as reported, but the shift towards MA was less dramatic.

As an aside, the Blue shift towards Medicare Advantage has apparently crossed a milestone. For the first time, the revenues of Blue offerings of MA exceed that of Medicare Supplemental. This is particularly remarkable considering that every Blue Plan in our universe offers Medicare Supplemental and only one-half offer MA.

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Marketing expense growth declined across universes although notably broker commissions and rating and underwriting grew robustly. The source of the decline in growth for Blue was an actual decline for advertising, while internal sales and marketing was a major factor for IPS plans in 2007. Overall, the health plans in our study appear to be favoring the more difficult to manage external distribution systems.

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The mix shift in favor of Medicare Advantage was especially evident in trends in provider and medical management. PMPM growth among Blues and IPS plans were 10.0% and 11.3%, respectively. But, backing out the effect of mix changes, Blue plans expenses grew by only 2.2% and declined by 3.2% for IPS plans. Managing the care for seniors is more demanding than for younger members of these plans and, because Blues have historically emphasized products with less active management, the changes in overall corporate operational requirements are even more dramatic.

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Account and Membership Administration growth was affected by greater emphasis on information systems. The rate of growth for IPS increased from 1.2% in 2006 to 4.8% in 2007. On a product mix adjusted basis, PMPM costs increased by 14.7% for IPS plans. For Blues the effect was also notable, though less dramatic. Growth is up from 2.9% in 2006 to 5.0% in 2007. Information systems cost growth was especially pronounced in four of the largest Blues, so much so that the slope of the scalable functions was actually positive on that account!

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Corporate services costs have been subject to remarkable cost cutting, with an increase of 0.2% for Blues and a decline of 3.4% for IPS plans. On a product mix adjusted basis, costs were down by 6.2% for the Blues, and down by 8.7% for IPS plans. Corporate executive and governance costs comprised the lion's share of the declines in both universes.

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In this discussion, we've seen that Blue and IPS plans have had similar trends. And actually they converge in other respects as well. It is often asked, especially by worried IPS plans, whether Blue Plans have lower costs than they. The concern has a sort of intuitive appeal when you consider that on average Blue Plans have 750,000 members compared with 250,000 for IPS plans, or are three times their size.

However, we generally see very little difference between them. Adjusting the IPS product mix so that it matches that of Blue plans, IPS administrative expenses are 8.7% or $2.35 higher PMPM. Adjusting Blues to match the mix in IPS plans, IPS plans are higher by a mere 0.9% or by $0.28.

The composition of the differences is also interesting. Corporate services costs are lower for Blues, a place where economies of scale in actuarial, finance and corporate executive are evident. But they are not lower in account and membership administration. The relative propensity of IPS plans to manage care is evident in the provider and medical management cluster: IPS plans do more of it. Finally, note that marketing costs comprise the lion's share of the differences between the two universes.

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When you look at the lowest cost ten plans by ones, you can see the importance of execution. While, in general, IPS plans are far smaller in size than their Blue counterparts, they are very well represented among the lowest cost plans in our study. This is one of the reasons we think that execution is king.

By the way, to do this ranking, we compared each of the plans to the combined peer group, matching the peer groups mix with that of the plan we ranked, thereby assuring comparability.

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I previously mentioned economies of scale. What is especially notable is how small a role they play in the context of total costs. As you can see scale has little predicative value on health plan administration.

In most years, perhaps 20% of expenses are scalable and the slope of the line is 85% or 90%. In other words, were a plan to double in size only 20% of its administration would be subject to scale at all and even those scalable costs would persist at 85-90% of the pre-doubling values.

Among Blue Cross Blue Shield Plans, this year, due to IS, costs were actually antiscalable. When IS is excluded, the proportions and slope of scalability remain similar to historic levels.

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There are differences in operating styles between larger and smaller plans, and they illustrate challenges of execution that face them all. Staffing, for instance, does seem subject to economies of scale. But one can infer (and we have found this to be the case when calculated independently) that non-staffing costs and compensation per FTE seem antiscalable.

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I mentioned the propensity of larger Blue Plans to spend more per member for information systems in 2007. This slide illustrates a similar sort of pattern, back in the early part of this decade. This chart shows the relationships between scale and costs for internet / ecommerce over time. The slope is positive in 2000, and generally rotates clockwise over the next three years. Larger Blue plans appear to have been early adopters of the new technologies, and they may be doing so again in 2007.

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The good news for any smaller plan is that great size is not in and of itself a "table stake" for success in this business. Neither is it an assurance of sustainable competitive

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advantage. As noted in a prior slide, five of the lowest cost plans are IPS plans, despite their much smaller size. To the contrary, we believe that execution is king.

For larger plans, their specific execution challenge may be to disprove the lack of scalability they appear to now exhibit. Going forward, that may be manifest in drawing the best performance from those non-staffing investments and higher compensated staff characteristic of larger plans.

<*Appendix slide follows. It describes the functional areas found in the each of the functional area clusters discussed in this presentation.*>

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